

A Work Project, presented as part of the requirements for the Award of a Masters Degree in
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**The effectiveness of the “*Processo Especial de Revitalização*” as an instrument of
corporate restructuring in the context of the current economic crisis**

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Abstract

This work project intends to evaluate the effectiveness of the Portuguese Government's strategy to promote the orderly deleveraging of the corporate sector in the context of the current economic crisis. The recommendations of the Troika and the commitments assumed under the Memorandum of Understanding signed by the Government in 2011 required the creation of formal processes to avoid disorderly deleveraging. Conclusions and recommendations were drawn based on past experiences of large-scale corporate restructuring strategies in other countries and on the analysis of financial and statistical data on companies applying for “*Programa Especial de Revitalização*”.

Key expressions:

Orderly deleveraging, *Revitalizar*, Large-scale corporate restructuring, *Programa Especial de Revitalização*.

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1. Introduction

This project aims at evaluating the effectiveness of the Portuguese Government approach to corporate restructuring in the context of the Euro area peripheral countries economic crisis, focusing on one of the key instruments of the restructuring program “*Revitalizar*” launched by the Government in 2012, “*Processo Especial de Revitalização*” (Special Revitalization Process or “PER”). PER is an instrument created by the Portuguese Government to promote, speed up and facilitate orderly restructuring of distressed corporations, avoiding court overloading and long lasting lawsuits that ultimately lead to corporate bankruptcy. This process has been widely discussed in the last few months and frailties have been pointed out in the latest reviews of the Portuguese economy made by the European Commission, the International Monetary Fund and the European Central Bank (together the “Troika”). As a consequence, the Portuguese Government has been re-evaluating its framework following the recommendations made by these three institutions.

The purpose of this work is to evaluate the degree to which PER has reached its objectives of providing an alternative solution to insolvency for viable companies by promoting creditor coordination and risk sharing. For this purpose, statistical evidence regarding the evolution of the number of insolvencies before and after the implementation of PER has been analysed. Furthermore, a research was conducted in a selected sample of companies that have applied for PER, evaluating their financial situation before the process, in order to determine whether these were in fact viable companies through their operational and financial performance. The results of this analysis will show that the PER has not been able to fulfil the objectives initially set out. As conclusion, this work will try to determine the main reasons for this and present a few possible recommendations on how to improve the efficacy of the program.

2. Corporate debt restructuring in financial crisis: a review of the literature

The latest economic crisis and tighter credit conditions have raised corporate debt problems across the world. If not dealt with in due time, these problems can have severe macroeconomic consequences and threaten the banking system, which is not able to provide additional credit. This situation creates a vicious cycle as corporates are unable to deleverage because of the recession and banks are unable to boost economic recovery due to undermined balance sheets. The intervention of central banks, despite minimizing the impact on the real economy, does not assess the true causes of the problem (Spaventa, 2008).

Solving corporate debt problem has therefore become an important part of recovery strategies in several countries. However, an abrupt and disorganized adjustment to corporate and banks' balance sheets can have severe consequences in the real economy, leading to spill overs to sovereign balance sheets and consequent high macroeconomic and financial costs, especially in countries with limited fiscal space, exchange rate restrictions and high dependence on external factors, such as Portugal. In order to avoid high deleveraging costs, the corporate restructuring process must aim at restoring corporate productivity and growth and a sustainable economic recovery (Goretti and Souto, 2013).

The purpose of corporate restructuring is therefore a timely and orderly restructuring of corporate liabilities in order to restore operational and financial health in distressed but still viable firms while liquidating non-viable ones (Grigoriani and Raei, 2010). In order to be successful and sustainable, strategies should include some form of operational restructuring addressing the structure and efficiency of the firm's business through closures and reorganization of production capacity (Laryea, 2010).

In the context of a deep economic crisis, where corporate debt problems are widespread and carry potentially sizable macroeconomic consequences, market failures can inhibit voluntary debt workouts. Rather than addressing unsustainable debt issues, firms and creditors often delay restructuring in the hope that economic recovery might bail them out, resulting in the proliferation of non-viable firms and further damaging credit conditions. In this context, government intervention may be necessary through legal, regulatory and financial reforms to support corporate restructuring as part of an economic adjustment process (Laryea, 2010).

Government intervention can take the form of i) a centralized approach, through direct financial assistance and/or the creation of specialized asset management public agencies (“AMC”) responsible for acquiring and disposing of distressed assets; or ii) a decentralized, creditor-led work-out approach, which relies on banks and other creditors’ initiative to solve NPL, where the government takes the role of a mediator, providing the appropriate legal foundations and incentives for out-of-court resolutions (Dado and Klingebiel, 2002).

Government involvement through direct financial assistance usually takes place when debt problems are pervasive and have negative externalities on the economy (Grigoriani and Raei, 2010). The adoption of this approach is limited to the degree of available fiscal space and impact on public debt sustainability. It can also cause inefficiencies and moral hazard issues, by shielding creditors and debtors from losses, preserving non-viable firms and excess capacity and encouraging risky behaviour going forward (Hagan, 2010).

The decentralized creditor-led work-out approach relies on banks and other creditors to resolve non-performing loans, based on the principle that banks have the highest incentives to maximize recovery value and avoid future losses. They are also able to provide additional funding when necessary and maintain payment discipline, often lost when credits are

transferred to external agencies. On the other hand, ownership links and corporate governance issues between banks and corporations are not dealt with and may become an impediment to corporate restructuring (Dado and Klingebiel, 2002).

The involvement of the government as mediator is necessary when court and administrative systems are weak and market failures or legal impediments inhibit banks of leading debt restructuring. In these cases, the government can play a constructive role in facilitating the orderly workout of debts, following the so-called London Approach, named after the measures taken by the Bank of England during the UK recession of the 1970's, which encouraged creditors and debtors to adopt a coordinated approach to minimize losses to creditors, avoid the bankruptcy of viable debtors and maintain financial support to viable debtors through out-of-court restructuring agreements (Grigoriani and Raei, 2010).

The strategy for dealing with corporate debt restructuring should be tailored to individual country circumstances and the dimension of the debt problem. Under this principle, intermediate approaches to corporate restructuring have been applied in many countries, which combine case by case analysis, government fiscal incentives and legal and regulatory reforms with the establishment of public agencies to galvanize debt restructuring (Laryea, 2010). Country data analysis also shows that often different strategies were applied depending on the size of distressed companies – large firms' debts are either worked-out voluntarily among creditors under government sponsored programs or liquidated and restructured under court supervision and smaller companies' debts are worked out on an out-of-court basis or under standard bankruptcy procedures (Claessens, 2004).

In general, when tailoring a corporate debt restructuring strategy to individual country circumstances a number of key factors should be taken into account, namely:

- a) Policy coordination: government intervention should consider the dimension and origin of corporate debt problems and the effects that policies may have on the success of the strategy in order to avoid common pitfalls and risks (Laryea, 2010).
- b) Analysis of data to assess the relative dimension of the debt problem and the implications for creditors, especially bank balance sheets (Hagan, 2010).
- c) Legal and institutional reform: effective insolvency systems facilitate the rehabilitation of corporations, provide an efficient mechanism for liquidation of unviable firms and help overcome coordination issues. In the context of a crisis, the effectiveness of an insolvency law can be compromised by market failures and the number of outstanding cases to be processed (Hagan, 2010). It is crucial that the insolvency law establishes incentives for out-of-court restructuring and provides courts with mechanisms to enforce restructuring agreements accepted by the majority of creditors on dissident ones (Laryea, 2010).
- d) Government support to facilitate out-of-court restructuring: international experience from past crisis indicates that some degree of government involvement in supporting guidelines for out-of-court restructuring facilitates wide scale debt restructurings (Laryea, 2010).
- e) Facilitation of voluntary standstills: Standstills are necessary to relieve firms from liquidity pressures and can be enough to sustain distressed companies through crisis averting them to fail due to the freezing of credit markets. However, in cases where a substantial proportion of the corporate sector is in distress, negotiating case by case standstill periods may not be feasible. Therefore, government incentives to creditor participation in standstills can be considered, namely through financial assistance (Laryea, 2010).
- f) Government involvement in new financing: reforming the insolvency law to give priority to new debt over existing facilities can be an incentive to new funding. Even though in a

credit crisis the cost of new money can be unbearable to firms, governments' direct involvement in providing direct credit to firms should be avoided (Laryea, 2010).

- g) Differing intervention for SME's: small and medium sized enterprises are usually the bulk of the corporate sector and therefore a differentiated approach should be defined for these companies as the banking and court systems do not have the capacity to efficiently restructure distressed SME on a case by case basis and their mass failure could have severe social consequences which further deteriorate macroeconomic conditions (Laryea, 2010).
- h) Coordination with financial sector restructuring: the rehabilitation of the banking sector is a key priority for crisis containment and resolution. In principle, banks prefer market-based approaches to debt restructuring to avoid costly and slow court-based bankruptcy procedures. However, in the context of a systemic crisis, coordination failures and externalities may inhibit progress. In these cases, government intervention may be needed to secure the availability of resources and the right set of institutional arrangements for negotiating parties (Grigoriani and Raei, 2010).
- i) Governance issues: ownership links between banks and borrowers can hamper the effectiveness of decentralized work-out strategies as the same party can be both debtor and creditor (Dado and Klingebiel, 2002).

Finally, the timeframe for implementing a corporate debt restructuring strategy is equally important as a concerted implementation cannot be sustained during the height of a crisis. In a containment phase, priority should be given to recapitalizing the financial sector, introducing legal and regulatory reforms and facilitating voluntary standstills on payments, setting the bases for wide scale corporate debt restructuring. Also, it should be clear that the liquidation of non-viable firms cannot and should not be avoided (Laryea, 2010).

The literature on corporate debt restructuring emphasizes the need for clear public policies to provide the right institutional framework and incentives for an orderly deleverage. The experience from former financial crisis points out the importance of private debt restructuring mechanisms in containing the delving effects of financial crisis on corporate structure and employment. The next sections will evaluate the Portuguese Government's strategy to promote and facilitate corporate debt restructuring. Even though the instruments created respond to several issues herein raised, this work project will try to demonstrate whether this program has been effective so far and what still needs to be done to improve its results.

2. Corporate restructuring in Portugal

1.1. Background and legal framework

In 2011, Portugal corporate debt leverage reached an average of 150% of equity and 60% of total corporate assets, a level among the highest in the Euro area. At the same time, firms' capacity to repay debt, proxied by the Interest Coverage Ratio ("ICR"), stood at less than 2, among the lowest in the Euro area. Since the onset of the global crisis in 2008, Portuguese firms made sizable adjustments to their operational balances, namely through the reduction in wage costs and by diversifying their activity abroad. However, the ability to boost foreign sales has been limited by the weak external demand from the Euro area and the need to achieve productivity and competitiveness gains through a more gradual internal devaluation process. As a result, there was a significant decline in firms' investment in fixed assets, translating into a sharp adjustment in domestic demand and record-high unemployment rate¹.

¹ **International Monetary Fund** "*Portugal: Selected Issues Paper*"

In past crisis episodes, restructuring processes have followed different approaches depending on country-specific circumstances and the severity of corporate leverage problems, ranging from direct government involvement to government-sponsored market-based models.

Given its limited fiscal space, the Portuguese Government has opted for a market-based approach. In 2012, following the Portuguese Government's request for financial assistance, a Memorandum of Understanding ("MoU") was signed with the IMF, the European Commission and the European Central Bank (together the "Troika"). In what concerned the corporate debt restructuring framework, the MoU included commitments regarding: i) the amendment of the insolvency law and the introduction of fast-track court approval procedures for restructuring plans in order to facilitate the rescue of viable firms; ii) the issue of general principles on voluntary out-of-court restructuring in line with international best practices; iii) the authorization for tax and social security administrations to use a wider range of restructuring tools in cases where other creditors agree to restructure claims, and review the tax law with a view to removing impediments to voluntary debt restructuring; and iv) the launch of a campaign to raise public and stakeholder awareness of the restructuring tools available for early rescue of viable firms through training and new information campaigns². In order to comply with the provisions set forth in the MoU, in May 2012, the Portuguese Government created the Program "*Revitalizar*" aimed at promoting the orderly restructuring of corporates in distressed situations. Under the program, two instruments were created for allowing debtor recovery outside the formal insolvency procedures:

- PER – "*Processo Especial de Revitalização*", a court-supervised recovery system;

² "*Memorandum of Understanding on Specific Economic Policy Conditionality*" signed between the Portuguese Government and Troika

- SIREVE – “*Sistema de Recuperação de Empresas por Via Extra-judicial*”, a system for out-of-court corporate restructuring.

These instruments respond to the first two commitments set out in the MoU signed with the Troika – the PER intends to be a fast track court approval procedure for restructuring plans; the SIREVE responds to the need for guidelines for out-of-court debt workouts. Both instruments aim at establishing a voluntary negotiation system between the debtor and the totality or, at least, the majority of its creditors, in order to reach an agreement that allows the full recovery of the debtor. In principle, it should only be initiated when there is a high probability of the debtor overcoming its financial difficulties through an agreement and that it can maintain its normal activity once the agreement is concluded³.

Processo Especial de Revitalização (herein “PER”) was created in 2012 by Law n. 16/2012 of 20th April, in order to introduce new recovery tools for companies undergoing financial difficulties. The purpose of the PER is to allow viable entities in distress or in an imminent insolvency situation, to establish negotiations with creditors in order to reach an agreement for rehabilitation. A distressed financial situation is defined as serious difficulty to fulfil obligations in a timely manner, due to liquidity constraints and inability to obtain credit.

The process may be used by all debtors that, by means of a written declaration signed by themselves and their creditors, affirm that they gather the necessary conditions for recovery. After sending the declaration to the judge of the competent courthouse, a judicial administrator is named and a communication is sent to all creditors stating the intention of starting the recovery process. From that point onwards, the process has a maximum period

³ IAPMEI and Governo de Portugal “*Programa Revitalizar: Guia para processos de recuperação de empresas*”

of 4 months to be concluded. During that period, all outstanding actions interposed against debtors and ongoing insolvency procedures are suspended and no additional actions may be initiated. Also, debtors are forbidden to take actions with relevant impact on their economic situation without previous written approval by the judicial administrator. If a final agreement is reached between the debtor and all creditors, the PER is automatically approved. If the agreement is signed only by a qualified majority of creditors, the court has the power to approve or deny the implementation of the agreement. In case an agreement is not reached within the defined timeframe, and the debtor was previously in an insolvency situation, insolvency is immediately declared and normal proceedings take place. In case the debtor was not in an insolvency situation it is up to the judicial administrator to decide whether it should be declared insolvent. In either cases, the debtor may not apply for PER for the next 2 years following the decision.

In terms of guarantees for creditors involved in the process, all guarantees agreed between debtors and their creditors during the PER in order to assure the necessary financial support for its recovery stay in place even if negotiations fail and insolvency is declared, for a period of 2 years. Additional funding provided during the rehabilitation has priority over all other credits, in case the recovery plan fails and the company is dissolved.

The SIREVE was introduced in September through Decree-Law n. 178/2012 of 3rd August for reforming and simplifying the pre-existing extra-judicial conciliation system. This program aims at simplifying recovery procedures by relying on IAPMEI, the Portuguese agency for support of small and medium sized companies, as mediator, responsible for assessing whether corporate candidates are eligible for restructuring, centralizing all necessary information, promoting the coordination among creditors and deciding whether the

proposed restructuring agreement is viable. Proposals must be based on a viable and feasible business plan, which identifies necessary measures for re-establishing the economic sustainability of the company and its ability to fulfil all conditions set in the restructuring agreement, namely by presenting provisional financial statements for one period that show a balanced financial and economic situation, namely a Financial Autonomy ratio of at least 15% to 20% and a General Liquidity Ratio of 1.05⁴.

1.2. Strengths and limitations

The reform of the insolvency law with the introduction of these two instruments responds to some of the criteria that define a good corporate restructuring strategy and follows other policies implemented by the Portuguese Government, namely aiming at restructuring the financial sector – they provide a fair opportunity of restructuring to all firms facing financial distress while maintaining the threat of insolvency; prepacked agreements negotiated out-of-court become enforceable if signed by a qualified majority of creditors; actions undergone by debtors and creditors which may harm the negotiations are prohibited during the negotiation period; proposals must be law abiding and approved by either judicial representatives or a government agency; and in case restructuring plans fail and insolvency proceedings take place, new debt granted during the negotiation period has priority over existing responsibilities, including debts to employees, social security and fiscal authorities. Furthermore, the Government has been involved in promoting new financing through the creation of specific guaranteed credit lines directed to be granted to SME by retail banks. In 2014, this credit line (“*PME Investimento*”) had a total amount approved of €2 billion.

⁴ IAPMEI and Governo de Portugal “*Programa Revitalizar: Guia para processos de recuperação de empresas*”

However in its 11th Assessment of the Portuguese Economy, Troika identified points that need to be addressed in order to improve the efficacy of “*Revitalizar*”:

- a) Insolvent companies often use the program to delay inevitable insolvency proceedings, overburdening the judicial system and further delaying the implementation of necessary restructuring plans for viable companies;
- b) Debtors and creditors often agree on insufficient restructuring plans, which do not include debt reductions, operational restructuring measures, or new funding, waiting for economic recovery to pull them out of distressed conditions;
- c) The out-of-court system, SIREVE, on the other hand, has been a non-viable alternative due to the inability of the IAPMEI to respond to requests and fulfil its part as a facilitator;
- d) Informal agreements are scarce due to high creditor dispersion, lack of coordination and unwillingness to provide new funding;
- e) Oversight of debt restructuring is weak with insufficient and fragmented information preventing an accurate analysis of the effectiveness of changes in financing conditions⁵.

Additionally, although this point was not identified in the IMF report, in what concerns the PER, the absence of an unbiased initial assessment of the financial situation of companies and of the feasibility of the restructuring plans being proposed encourages strategic behaviour from both debtors and creditors and increases the probability of initially approved restructuring plans being unsuccessful and ending up with the insolvency of the debtor.

Given the above described limitations, the main purpose of the program, which is to rehabilitate viable companies and dissolve unviable ones, is not being attained – viable

⁵ **International Monetary Fund** “Portugal: Eleventh review under the extended arrangement, and request for extension of the arrangement and waivers of applicability of end-March performance criteria”

companies face insufficient restructuring conditions and remain in a fragile financial situation and insolvent companies drag their situation even further, increasing creditor losses.

3. Data analysis

1.1. Methodology

To analyse the efficacy of “*Revitalizar*” this work project will focus on PER, since there is no publicly available information for SIREVE. The Ministry of Justice’s portal *Citius*, in which all procedures related with insolvency and PER are registered, was used to list the companies that filed for PER between May 2012 and December 2013. Afterwards, a database was created containing financial information on each company for the past 9 years, namely key performance indicators such as turnover, EBITDA, financial debt, equity and interest expenses and a few key ratios were computed in order to have a general overview of their operational and financial performance before the implementation of restructuring programs. The purpose of this analysis was to have an idea of whether the majority of companies applying for a PER were sound companies facing financial difficulties under the crisis or whether there was a significant proportion of those companies facing financial difficulties and unsustainable leverage levels, hardly be overcome through financial restructuring.

The selected sample consisted of 825 firms that filed for PER and for which financial data was available in the *Sabi* database. It should be mentioned that not all data was available in all the years considered in the analysis. Therefore, conclusions are made in relative terms considering the number of companies for which there was available information in each year. Additionally, statistical data regarding the evolution of insolvencies and PER was analysed

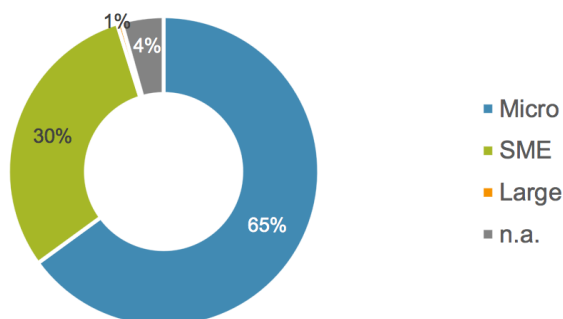
in order to determine whether the PER has contributed to decrease the number of bankruptcies in the corporate sector and to improve credit recovery ratios.

A relevant complimentary analysis would be to evaluate the performance of the firms for which a restructuring agreement was reached in order to see if there were significant operational and financial performance improvements in the years that followed the PER and also to observe whether debt restructuring included haircuts or new money, a standstill period or an interest reduction. However, given the recent history of the legislation and the scarcity of financial data for the majority of companies in 2013, this analysis was not performed as its conclusions would not be broad or accurate enough.

1.2. Data Analysis

The sample of 825 firms that applied for a PER between May 2012 and December 2013 is characterized by a majority of Micro or SME's, together representing 95% of the total number of companies analysed (of which 65% are Micro companies and 30% SME)⁶.

Chart 1 – Distribution of sample by size

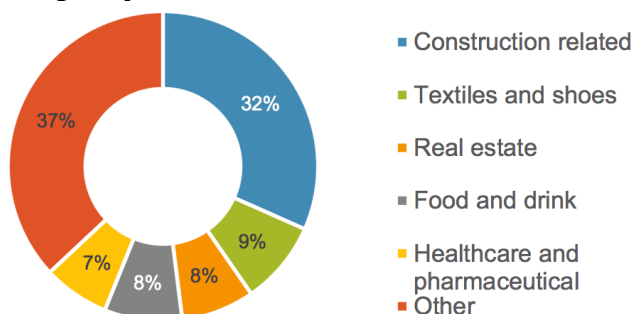


Around of these companies operate in construction or construction related activities, with a significant proportion of textile, real estate and pharmaceutical companies also filing for

⁶ Micro firms employ up to 10 workers or which generate a total turnover below or equal to €2 million. SME's employ between 10 and 250 workers or have a total turnover between €2 million and €50 million.

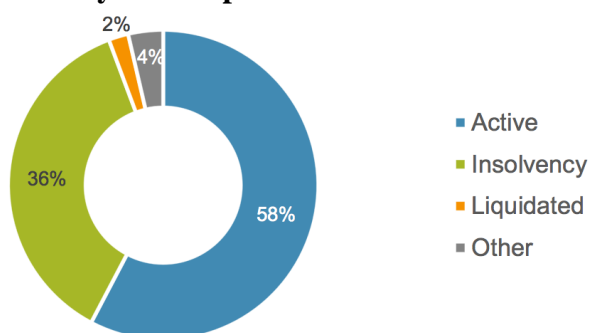
rehabilitation process. These were the most affected sectors during the crisis and therefore their representativeness in the sample matches initial expectations.

Chart 2 – Distribution of sample by business sector



From the 825 companies herein observed that initiated rehabilitation programs between May 2012 and December 2013, only 476 remain active (58%), with the percentage of liquidated or dissolved companies varying little across business sectors. This may indicate that either they were not viable companies or that the recovery process was not effective, possibly due to lack of coordination among debtors and creditors. It is important to mention that many of the processes filed had lists of creditors that included more than 20 different entities, which supports the idea that a consensus under these conditions is difficult to be achieved.

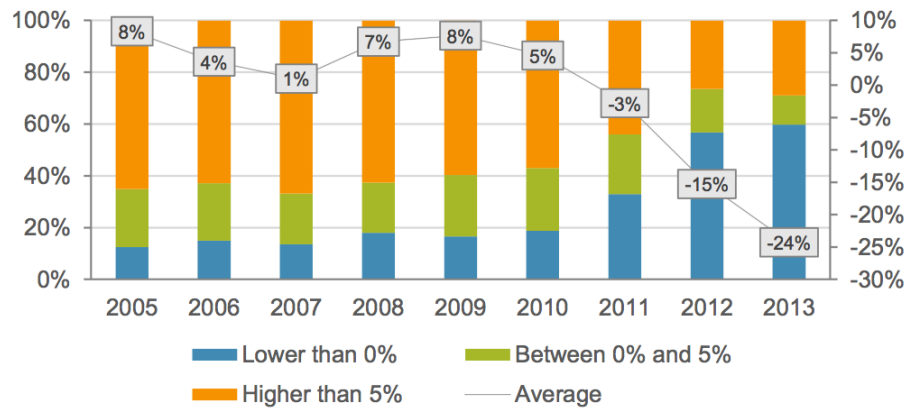
Chart 3 – Current status of analysed companies



Looking at financial data available for the selected companies for the last 9 years, it is possible to observe a severe decrease in operational performance since 2010, consequence of the economic recession and restricted access to funding. However, despite the decrease in

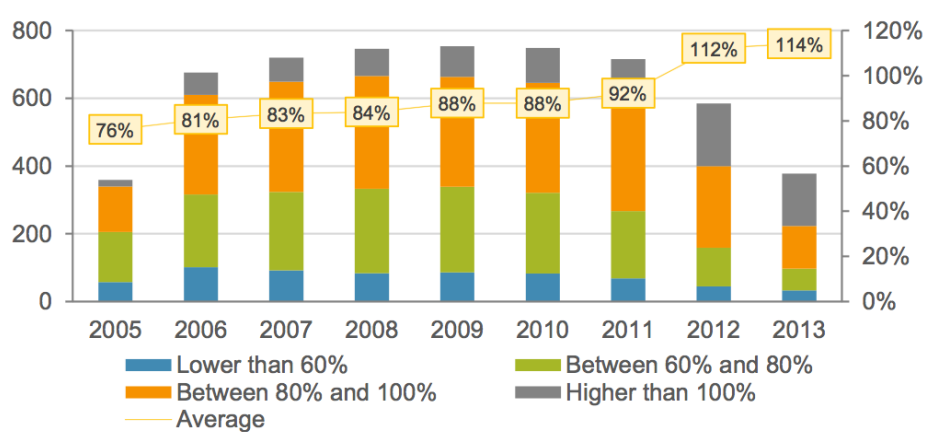
performance observed since 2011, operational margins were not exceptionally high in the previous years, with only 30% to 35% of companies registering margins above 10%.

Chart 4 – Evolution of EBITDA Margin



Considering the leverage of these companies, it is possible to conclude that the average level of indebtedness was above sustainable levels and had been so for several years, especially considering the fact that most of them are Micro companies and SME’s.

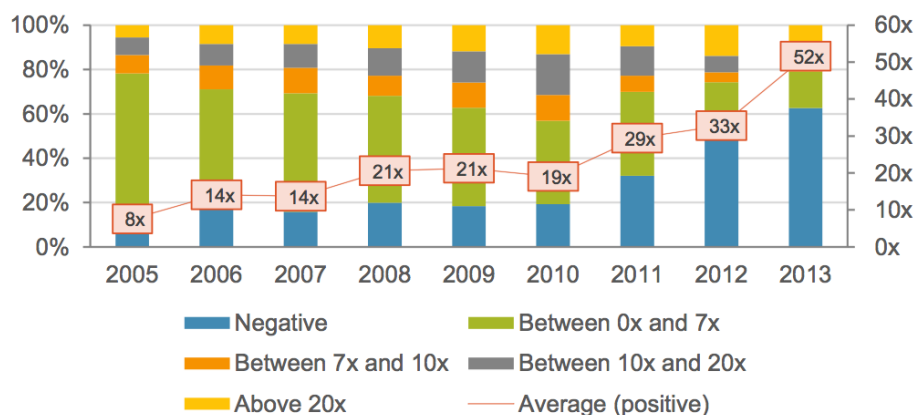
Chart 5 – Evolution of the level of indebtedness



Excluding negative ratios caused by negative EBITDA levels and eliminating extreme values that distort the analysis and bias conclusions, an average level of the Debt to EBITDA ratio was computed for each year. Despite the fact that optimal levels of debt may differ considerably across business sectors and company size, the average values obtained are well

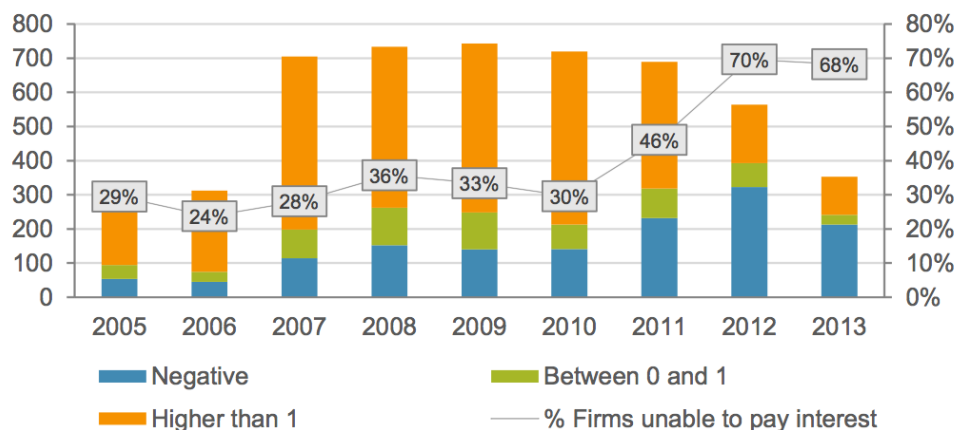
above the levels that could be considered acceptable for any industry, indicating that at least a significant number of companies was facing a risky financial situation before the recession.

Chart 6 – Evolution of Debt to EBITDA ratio



This statement is confirmed when ICR are computed. Between 2005 and 2011, a third of the companies under analysis were unable to pay interest, indicating that a high number of companies had an unsustainable level of indebtedness before the credit crisis hit its peak.

Chart 7 – Evolution of Interest Coverage Ratio (“ICR”)



Looking specifically at the real estate sector, which is one of the most vulnerable sectors to changes in economic environment, on average, between 2005 and 2011, more than 32 of the 63 real estate companies that filed for recovery plans in 2012 and 2013 had an ICR below 1.

With the aggravation of the real estate market conditions, which led to general devaluation of assets, and the higher restrictions in additional loans, by the time they filed for a recovery plan, most of these companies were likely struggling to remain active, with limited prospects of improvement, placing them among the category of unviable firms. In fact, in the end of 2013, of the 63 companies, 23 had been liquidated or started insolvency proceedings.

This analysis supports the idea that, contrarily to the purpose of the restructuring strategy initially designed, which was to rehabilitate viable companies and facilitate the liquidation of non-viable ones, the PER has been used by firms that even before the recession had been facing distressed situations and unsustainable financing structures.

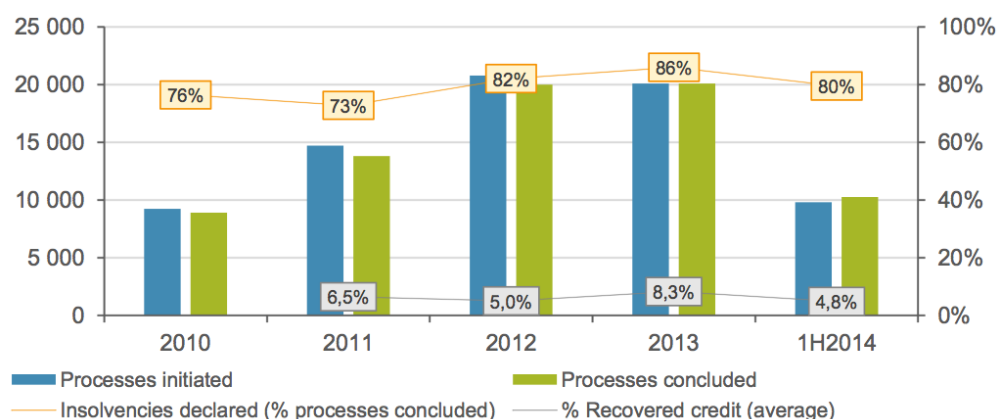
1.3. Statistical evidence

In the last three years the number of processes for insolvency and company recovery has increased by an average of 30% a year. The numbers for the first half of 2014 indicate a slight improvement relatively to the same period of 2013, but the levels should not differ substantially from 2012 and 2013. From the total number of processes concluded, around 80% ended with debtor insolvency. This number has not changed substantially since 2010 and even shows a slight increase since 2012, the year when “*Revitalizar*” was created. Also, credit recovered compared with the total amount of credit claimed remains low since 2011, despite the instruments introduced to facilitate restructuring⁷.

Finally, despite the increase in the number of PER requests entering the system, the success rate has not changed since the introduction of this mechanism, remaining slightly below 50%.

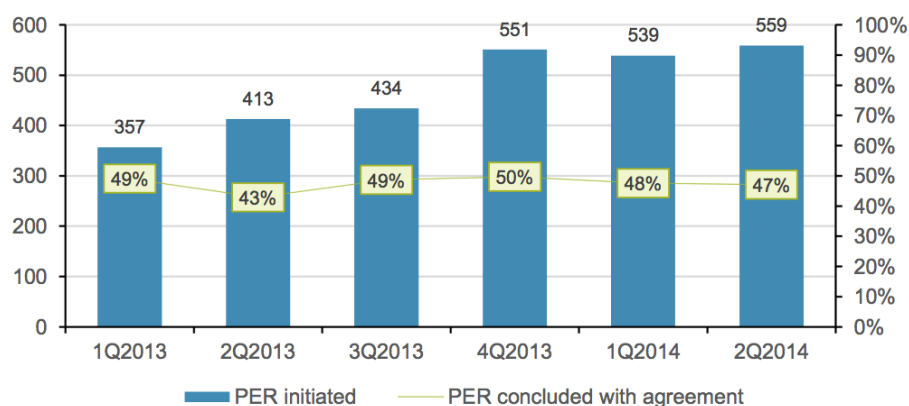
⁷ **Direcção-Geral da Política de Justiça** “*Estatísticas trimestrais sobre processos de falência, insolvência e recuperação de empresas e sobre processos especiais de revitalização*”

Chart 8 – Evolution of insolvency and recovery processes in courts



This statistical data supports the initial assessment made by Troika that the instruments created by the Government to promote orderly deleveraging of the corporate sector, so far, have not been able to fulfil their purpose. The number of insolvencies increased sharply between 2011 and 2012 and remained relatively constant ever since. Also, the amount of credit recovered in a liquidation scenario is usually much lower than the amount of credit that can be recovered if a recovery plan is put in place, for reasons that have to do with the long term sustainability of recovered firms and their ability to repay debt to their creditors. This can be an indicator of the low level of success in the negotiation of recovery plans, reinforced by the fact that less than half the PER initiated are concluded with an agreement.

Chart 9 – Average success rate of PER



The low level of success in negotiations is related with the fact that many of the companies filing for PER do not gather the requirements for a feasible and sustainable recovery plan, and with the large dispersion of credits and consequent difficulties in coordination.

4. Conclusion

The excessive leverage of the Portuguese corporate sector in the context of an economic recession and credit crisis has led to a sharp increase in the number of bankruptcies, raising social, economic and financial costs. In order to avoid an abrupt adjustment which would further damage economic conditions, it was important that the Government set up the conditions for promoting an orderly deleveraging of the corporate sector, creating the right incentives for the operational and financial restructuring of viable companies while maintaining the mechanisms for the timely liquidation of insolvent ones.

The strategic program “*Revitalizar*” created in 2012 responds to some of the conditions considered necessary for a successful corporate restructuring program by introducing a fast track court approval process for restructuring plans and incentivizing out-of-court restructuring in order to release the burden from the legal system. However, its full purpose has not been achieved, as shown by the low level of success in negotiations and the large percentage of companies that, after requesting for a restructuring plan, end up filing for insolvency. The analysis carried out during this work project indicates that this is mainly due to i) lack of coordination between creditors given the large dispersion of credits; ii) poor assessment of initial economic and financial conditions of companies applying for restructuring plans; and iii) resistance to implement operational restructuring measures from companies and to provide additional funding from banks.

These issues still need to be addressed in order for the program to achieve the desired result, which is to provide viable companies with an alternative to insolvency while maintaining fast liquidation mechanisms for companies that cannot be recovered. This would remove the excessive burden on the judicial system and avoid further economic and social costs, contributing for the soundness of the financial sector and the recovery from the recession.

Besides these, other limitations regarding the efficacy of restructuring measures could be identified, if enough data were available for the periods following the implementation of restructuring plans. The initial purpose of this work project included an analysis of such measures, namely, whether debt restructuring plans included standstill periods, haircuts and debt relieves, debt/equity swaps, interest rate reductions and maturity extensions. However, data on this subject is scarce and highly fragmented, given its recent nature and the absence of more recent financial reporting information for smaller companies undergoing restructuring, making it impossible to take relevant and accurate conclusions on this matter. It is also important to note that “*Revitalizar*” did not target the largest Portuguese companies in distress, since, on the back of higher capital and lower leverage requirements that arose from the 2008 crisis, the Portuguese financial system implemented balance sheet optimization measures in an environment where private capital sources were not available.

5. Recommendations

On its 11th review of Portugal the IMF staff defends that the development of efficient out-of-court workouts with standardized conditions for debt restructuring for large numbers of distressed but viable SME’s would be advisable to provide meaningful relief to firms, while encouraging bank-led and time-bound negotiations, supported by stronger mechanisms to foster creditor coordination (e.g. inter-creditor agreements), for larger companies. The report

adds that to enhance its effectiveness, the restructuring program should i) be subject to oversight by, and enhanced reporting to a reputable and well-qualified entity; ii) incorporate time-bound arbitration procedures to settle disputes among creditors or between creditors and debtors; and iii) include financing support for viable companies undergoing restructuring as an incentive for firms to enter into restructuring before their viability is in jeopardy⁸.

Most of the companies that applied for restructuring under “*Revitalizar*” have been Micro companies and SME. Given their individual importance, banks may be less willing to initiate restructuring procedures. Defining standardized restructuring conditions for SME’s would decrease the level of uncertainty in the beginning of negotiations and facilitate coordination. Although not mentioned in the IMF report, ranking companies according with their importance in the economy, level of distress and probability of recovery could also be considered, focusing attention and resources on companies that operate in strategic sectors, employ a large number of workers, and can more easily overcome financial difficulties. Furthermore, banks should be prepared to deal with debt restructuring in an efficient manner. Even though some banks already have special units dedicated to restructuring credits, most of them still lack the necessary internal coordination for dealing with these procedures, which further damages their capacity to reach consensus with debtors and other creditors.

For example, after the 1997 crisis, Korea implemented a corporate restructuring model that included an out-of-court procedure, in which all steps were perfectly identified, from the initial assessment of the company’s viability to different restructuring alternatives that could be considered. It also included the signature of a restructuring agreement between banks and

⁸ **International Monetary Fund** “*Portugal eleventh review under the extended arrangement, and request for extension of the arrangement and waivers of applicability of end-March performance criteria*”

the main companies under distress. In what concerned SME's, each bank was to create a specialized task force responsible for classifying companies in three categories – priority support, conditional support and other. For the first two categories, banks were to roll over loans maturing within one year, while the central bank adjusted credit ceilings to encourage further support to small firms. Government support was provided in the form of guarantees and restructuring funds, to be progressively reduced in following years (Sohn, 2002).

Increasing supervision and reinforcing provisioning policies are also ways to increase banks' incentives to restructure existing loans for smaller size companies. In many countries that experienced large-scale corporate deleveraging (Indonesia, Korea, Malaysia, Thailand, Mexico and Turkey) coordinating bodies were created to supervise the implementation of restructuring strategies and provide forum for negotiations and arbitration (Claessens, 2004). In order to separate viable from insolvent firms and enhance the success rate of restructuring plans, it is important to name an independent and professional entity responsible for evaluating the viability of the companies and the feasibility of restructuring plans. In Spain, for example, the approval of out-of-court agreements is subject to presenting a business plan duly certified by a specialized independent entity (Grigoriani and Raei, 2010). Even though the SIREVE includes the same condition, according with the IMF, the IAPMEI faces severe constraints in evaluating business plans and has not been able to facilitate the utilization of this instrument. Also, the feasibility of the PER is judged by court administrative bodies which lack the knowledge and experience to assess the viability of companies and the sustainability of restructuring plans. Therefore, a list of independent entities with experience in financial analysis and business plan evaluation duly certified by the Government could be selected, for debtors and creditors to choose from.

In order to prevent similar situations from occurring again in the future, the existence of proper monitoring procedures and tools in financial institutions is essential as well as proper supervision. Additionally, financial support should be provided for viable companies willing to implement restructuring measures before reaching a distressed situation. This would promote operational restructuring and decrease insolvency risk.

In Korea, after the measures implemented immediately following the 1997 crisis, a second phase was implemented, which promoted corporate restructuring on a regular basis. The *Corporate Restructuring Promotion Law* defined that debtor companies holding credits from financial institutions above KRW 50 million (approximately €37.5 million) were to be monitored and restructured in a timely and efficient manner. Banks were to perform periodic analysis of these companies and their business plans, separating viable firms facing temporary liquidity problems, for which additional support would be provided, from non-viable firms, to be liquidated. This process would be constantly supervised by the Financial Supervisory Commission. Additionally, cooperation mechanisms were created between financial institutions, including a creditor committee responsible for identifying troubled companies, evaluate co-management strategies, indicate loan expiration dates, adjust loans or newly granting of credit, and discuss management normalization procedures. Financial institutions which did not agree with decisions of this committee would have an option to acquire credits and manage them on their own (Sohn, 2002).

Finally, changes in the capital structure of companies should be stimulated, by reinforcing equity and reducing the dependence on bank loans. Restructuring tools such as debt/equity swaps and measures such as asset sale for debt repayment should be promoted, namely through tax incentives, as done in both Korea and Russia (Grigoriani and Raei, 2010).

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